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Financial Markets

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As the calendar year draws to a close, the various financial houses tally their profits and reflect upon the year nearly gone by. The year was filled with events of financial innovation, financial distress (particularly with several LDCs), and a markedly different monetary policy by the Federal Reserve. One can convincingly argue that Fed policymaking has changed in part because of the other two elements: financial distress and innovation. Let's take a brief look at such an argument.

First, recall that the Fed had embarked on a new course of policymaking in October of 1979. Under that policy, monetary aggregates pushed interest rates out of the limelight. Operationally, this meant that the Fed would emphasize the reserves required by the banking system to keep the Fed's prime aggregate (M1) within its target range. When M1 grew too fast, the banking system would require more reserves to support the higher level of money balances. The Fed would respond by not accommodating the banks' excessive reserve demands of this type. Thus borrowings at the Fed window would be (more or less) automatically triggered and pressure on interest rates would also follow almost automatically from above-target money growth.

The most casual of retrospectives on 1983 would indicate a total absence of this type of automaticity. The Fed ran what I would call an organic monetary policy in response to the uncertainties of the time: Financial innovation meant that money growth per se did not send a clear signal--monetary targeting itself became less meaningful; and financial distress, both at home and abroad, meant that the Fed could not be as indifferent to interest rate swings as it had been in the past. Thus the second phase of monetary policymaking under aggregates targeting has different characteristics from those it displayed in its infancy--this is not surprising.

While in its infancy, strict monetary targeting had to establish its credibility. This was done through the unprecedented interest rate volatility in 1980. Afterward this credibility became a liability of sorts. Having once raised interest rates well above historic peak levels, the Fed might do this again. Thus the Fed has had to become more pragmatic and eclectic because the market came to respect the Fed even more than it had in the past--and rightly so. At the same time, financial innovation made it much less clear how the Fed should respond to money growth. So with the market even more tightly focused on the Fed, it has had to be much more careful that its own response is correct.

The Fed's own lack of certainty has, in 1983, led it to introduce a credit measure as an added element to its batch of targeted aggregates. At the same time, the Fed has watered down M1 by changing the target at mid-year, calling it a monitoring range, and making Fed response to M1 conditional upon its "velocity" characteristics. Taken to the extreme, this approach throws targeting out the window. Reserve requirements on deposits contained in M2 and M3--but not in M1--are such a small factor in the short run as to not affect monetary policy. Technical factors involved with monetary innovation are one reason for the Fed's greater caution and lesser reliance on M1 alone. But so is the realization that the world economy is sensitized to changes in U.S. interest rates. We have yet to see which of these factors dominates the thinking within the FOMC.

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Market Yields

	12/23/83(Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	11.50%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	8.50
Federal Funds	9.00	9.75	8.75
Repurchase Agreements	9.00	9.70	8.75
U.S. Treasury Issues			
Bills			
3 months	9.22	9.47	8.02
6 months	9.68	9.82	8.43
1 year	10.06	10.07	8.74
Coupons			
2 years	10.82	10.84	9.58
4 years	11.29	11.43	10.11
7 years	11.68	11.84	10.71
10 years	11.75	11.88	10.58
Long Bond	11.84	11.95	10.67
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.75	10.05	8.70
3 months	9.75	10.00	8.70
6 months	9.85	10.10	8.85
1 year	10.15	10.80	9.25
Banker's Acceptances			
1 month	10.02	10.22	8.70
3 months	10.19	10.24	8.75
6 months	10.45	10.37	8.95
Eurodollar Deposits			
1 month	10.25	10.63	9.56
2 months	10.25	10.56	9.56
3 months	10.25	10.56	9.69
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	8.89	9.90	8.63
1 month	9.91	10.12	8.68
3 months	9.71	9.78	8.54
Bank Holding Companies			
1 month	8.94	9.45	7.40
Dealer Placed:			
3 months	10.03	10.24	8.41
New AA Corporate Utility Bond	13.15	13.20	12.40
Tax Exempt			
6 month Project Notes	5.55	5.60	4.70
1 year AAA Bond	5.80	5.80	5.00
5 year AAA Bond	7.25	7.45	6.70
20 year AAA Bond	9.40	9.80	9.20

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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